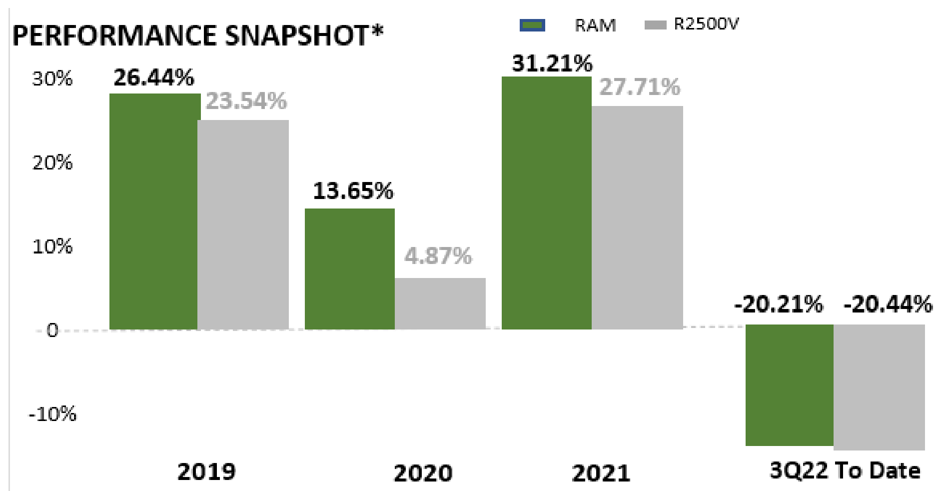
October 2022

The aggressive actions of the U.S. Federal Reserve to raise short term interest rates pummeled investor sentiment and the market indices in the third quarter. All the broad market averages declined, with the S&P500 down 4.89% and the Nasdaq down 3.91%. Our RAM Smid cap strategy declined 6.89%, compared to our benchmark the Russell 2500 value index, which fell 4.50%. Year-to-date, our strategy continues slightly ahead of the R2500V on a relative basis, down 20.21% vs. 20.44%.[1,2]

As we have discussed in our letters and Market Musing blogs, we anticipated higher Fed rates and inflation for some time. We believe we have positioned our portfolio in companies that can take advantage of the current economic backdrop, through the ability to raise prices to combat inflation, to increase earnings through higher interest income and to deliver on stated goals to increase investor interest and share prices. We don't own 'the market' and we are not trying to 'fight the Fed'. We believe the Fed will raise rates towards its current projections of 4.0%+. As such, we believe the larger and growthier sectors are still overvalued and vulnerable to multiple compression. We continue to see compelling value in the 26 companies we own in our RAM Smid strategy.



Source: Rewey Asset Management, Index returns sourced from Bloomberg 9/30/2022.

Please note that there are material limitations inherent in any comparison between RAM Smid strategy and the R2500 Value Index. The R2500 Value Index is unmanaged and you cannot invest directly in an index. The RAM portfolio is actively managed and holds concentrated investments in the equity securities of small-mid capitalized companies.

It Mattered When It Mattered: The Fed Dominated 3Q22

Fed Chairman Powell's eight-minute speech at the Jackson Hole conference August 26th strongly delivered the Fed's determination to raise rates until spiking inflation was quelled. In our view, he sought to crush any lingering views that the Fed was still hoping for a "transitory" ebb in inflation.

On September 21st, the Fed hiked Fed Funds rates by 75 basis points, to a range of 3.00%-3.25%, and indicated more hikes were likely. Two sentences from the Fed's statement/press conference stand out[3]:

- "We are moving our policy stance purposefully to a level that will be sufficiently restrictive to return inflation to 2 percent."
- "…without price stability, we will not achieve a sustained period of strong labor market conditions that benefit all."

Further, the Powell speech indicated the Fed's new Fed Funds target for year-end 2022 was 4.4%, and would peak in 2023 at 4.65% to ensure inflation slows. And, the statement concludes with the whopper:

- "Reducing inflation is likely to require a sustained period of below-trend growth, and there will very likely be some softening of labor market conditions."

In our view, the last sentence crushed market sentiment because it indicates, despite its long-term goal of a "strong labor market", the Fed now wants to see softness in GDP and labor markets. It believes this softness is necessity to drive a fall in inflation from the 8.3% reported for the August CPI, to its projections of 5.4% for median PCE inflation by year-end 2022, 2.8% in 2023, 2.3% in 2024 and 2% in 2025.

At quarter-end, investor sentiment appears to remain extremely negative. It seems that the economists and TV/radio pundits who were overwhelmingly bullish in March, now are racing oneanother to project ever worsening forecasts.

Not Like Any Recession I've Seen

We see several aspects of the current economy and capital market structure that do not rhyme with the set-up for the recessions that we clearly remember living through, in 1980-1982, 1990, 2001 and 2007. These recessions all followed a period of strong consumer and industrial excess, and began with softening demand, soaring unemployment and rising bad credit.

What Is Different This Time?

1. **Employment is robust**. US non-farm payrolls rose 315 thousand in August and have risen 3.5 million August YTD. Moreover, average hourly earnings are up 5.2% August YTD. Incredibly, the Bureau of Labor Statistics job opening survey, JOLTS, showed 11.23 unfilled jobs in the US as of July 31st.[4] Too few people to fill too many jobs is not like any recession we have seen.

2. **The Supply Chain Crunch and Demand:** Demand for many industrial and durable goods continues to far outstrip supply. Driven by Covid lockdowns, remote work, labor shortages, and a Just-In-Time supply chain that has gone Just-To-Far, most industrial companies we speak with all report healthy demand, if

not rising backlogs, but sales weakness due to the inability to get parts to meet demand. These shortages have left finished goods inventories for many goods at extremely low levels, and have driven prices higher, as strong demand and weak supply typically do. Since inventory levels are lean as we enter into a potential slowdown, we think we are less likely to see aggressive production cuts from the industrial sectors, but instead moderating pricing levels as production levels catch up to demand. Strong Demand and weak Supply is not like any recession we have seen.

3. **Reshoring:** We believe its real and could likely bolster the industrial sector through a potential slowdown. Most companies we speak with are fed up with extended overseas supply lines and are taking action to build up their domestic production footprint. Several companies we have spoken with have acknowledged new reshoring contracts that will begin over the next few months. The passage of the CHIPS and Science Act on August 9th further bolsters this trend with $280 billion marked for U.S. research and investment over the next few years.

4. **The U.S. Banking system is very healthy**. The capital restrictions imposed on U.S. banks post 2007-2009, notably an 8% Tier 1 capital minimum, have dramatically improved the position of today's bank balance sheets. This fact was, in our view, proven in the Covid crisis, where banks were called upon to lend Paycheck Protection Funds (PPP) to literally save the U.S. economy from a crash. This is in stark contrast to 2007, where low capital levels and bad loans forced a government bailout of the banks.

   Bank credit also remains pristine. As banks were forced to build equity over the last decade, they necessarily improved their credit standards and walked away from the riskiest parts of the credit markets. Also, accounting standard changes by the FASB, specifically Current Expected Credit Losses or "CECL", have further built reserves on current bank loans, likely mitigating future capital hits if credit does weaken. With strong balance sheets, a healthy credit and rising interest rates to bolster income, the banking system doesn't look like a cause of major concern if an economic slowdown develops.

5. **The rise of ESG and Activism:** Since the last recession in 2007-2009, there has been a dramatic rise in the role of the investor on company managements. Governance, the G in ESG, has amplified the actions and accountability of management teams and their capital allocation decisions. While this pressure is hard to quantify, it has in our view led to less leverage, more capital return to share holders and fewer over-priced and risky acquisitions. Likewise, the rise of activism has provided the "stick" to the ESG "carrot" as management teams that do not undertake prudent capital allocation decisions are more likely to face board challenges, or even take-over offers, if equity valuations continue to lag intrinsic value levels.

6. **The Federal Debt:** $30.87 trillion reasons to keep long-term interest rates low. The U.S. Federal Debt continues to surge. It is in the interest of the government to keep interest rates as low as possible to minimize the debt service interest on this debt. We think this debt level is another reason the Fed will push for a rapid return to inflation in the 2% range, which should support moderate economic growth

for the long-term. Of the three ways we see to deal with high debt, (default, inflation or growth) we think moderate long-term growth is in everyone's best interest.[5]

What Do These Differences Mean?

While we don't dispute that higher rates will slow the rate of economic growth, we do not see anything broken in our economy that would suggest we are staring into a prolonged recession or depression. While soft landings are hard to achieve, our view of the economy is one where growth slows to level that allows the inconsistencies of the labor market and the supply chain to normalize. This normalization should naturally slow inflation, or pricing power, as Supply rises and Demand moderates.

We think that by year-end, the Fed will be near completion of its rate hike campaign, and the market will begin to discuss 'green-shoot' scenarios like stabilization and recovery. If negative sentiment does create a reality of a much weaker economic environment than we are expecting, would would expect the Fed to act rationally and halt rate hikes, or trim target levels with cuts, as it tries to keep the economy in a slow growth mode and long-term inflation at 2%.

Portfolio Highlights

We believe our RAM Smid portfolio is well positioned for continuing economic strength, rising rates and moderating inflation, and is also very attractive from a valuation perspective. Focusing on the balance sheet, eight holdings are trading under book value and nine additional holdings are trading at less than 1.5x book. It is also worth highlighting that five of our holdings have no sell-side coverage, and ten others have five or fewer covering analysts. We believe this anonymity provides us with the opportunity to identify companies that pass under the radar for other investors, and help secure positions at attractive valuations.[6,7] At quarter-end, our RAM Smid cash level averaged slightly over 8.0%. We added five new companies to the portfolio in the quarter, and sold out four positions.[8]

Cadence Bank (CADE) was RAM Smid's top percentage gainer in the quarter. Cadence is the new name Bancorpsouth assumed, post its acquisition of Cadence Bank on 10/29/21. In addition to our bullish view on regional banks, we see the additional drivers of merger synergies and the attractiveness of its faster growing U.S. South markets as catalysts for value creation at CADE.[9]

Strattec Security Corp (STRT) was RAM Smid's largest percentage decliner in the quarter. Shares weakened post its 2Q22 earnings report, where deliveries of its starters and electric motors to automotive OEMs were delayed due to the supply chain crunch. As STRT has no active sell side coverage and market cap of just $83 million, STRT, in our view was vulnerable to negative market sentiment and thin liquidity around quarter-end. Our conviction in the name remains high, as we see a strong balance sheet, a visible path to revenue and earnings acceleration and a extremely attractive valuation.[10]

Orthofix Medical Inc. (OFIX)

We continued to build our position in Orthofix Medical Inc. (OFIX) in the quarter, as the stock price weakened on what we see as temporary revenue and profit headwinds from Covid and increased internal investment. OFIX is a $384 million market cap healthcare company with 2022 revenue estimates at $460 million. OFIX specializes in orthopedics and spinal care, with offerings in both durables and biologic therapies. Shares of the company closed the quarter at $19.11, down 47% from its March 2022 high of $36.12, and down a whopping 74.3% from its all-time high of $74.44 in February of 2019. We believe the market now underappreciates the internal improvement, partnerships and acquisitions CEO Jon Serbousek has led since joining in October 2019 and see the revenue and profitability momentum from these actions beginning to build a multi-year growth path in 2H22.

We see Orthofix's financial strength as a rarity in the healthcare space. As of June 30th, OFIX has almost $60 million net cash, with no debt and an undrawn credit line of $300 million. This cash position is after the company invested an incremental $15 million in inventories in 2Q22 to combat the impact of the supply chain crunch. While this inventory build impacted free cash flow for 2022, we see strong cash flow growth going forward, from sales leverage and a tailwind from D&A that has typically runs slightly over CAPX levels.

Orthofix believes it can achieve a high-single-digit revenue growth CAGR over the next few years, and we see a visible mix of near-term and long-term opportunities which should allow it to meet this goal. In the near-term OFIX is likely to see a reacceleration of hospital procedures that fell off during Covid, and the subsequent staffing shortages at hospitals that led to deferred procedures. Spinal and orthopedic procedures are strong pull through drivers for OFIX's biologics businesses, which represent roughly 50% of revenues. OFIX should also see building momentum from sales of its M6-C cervical disc, which received FDA approval in 2019, just before Covid slowed most discretionary hospital procedures. This industry leading 6-directional motion disc has over 60,000 placements internationally, 37,000 of which have been in place for over seven years. Similarly, OFIX should see continued growth from its Fitbone acquisition, completed in 2020, which leads the industry in internal bone lengthening solutions. Other near-term revenue drivers include OFIX's Interbodies business, growing biologics revenues from its MTF Biologics partnership and the new authorization of its Accel Stim device for ultra-sound therapy for bone fracture healing. The investment in 2022 to build out its global commercial footprint should also support revenue growth and margin expansion going forward.

Over the long-term, OFIX has a powerful growth outlook, driven by internal investment and acquisitions. We see three stand-out long-term internal growth opportunities. OFIX has a clinical trial underway for its rotator cuff soft-tissue stimulation repair device, which if approved, could serve a market of approximately 650,000 annual procedures in the U.S. alone. OFIX is also starting U.S. trials of the Novisis rhBMP-2 bone growth factor through its partnership with CGBIO, a market that could reach $650-$950

million. Last, OFIX continues to build out offerings from its Fitbone acquisition, and sees a potential $400 million opportunity from its potential Fitspine product that could address pediatric and adolescent scoliosis. Inorganically, OFIX continues to search for synergistic technologies to acquire or license with its balance sheet firepower. We believe the market is ascribing little if any value to these potential growth drivers.

We see strong potential upside from a valuation perspective. OFIX has guided 2022 revenues to roughly $460 million, with gross margins of approximately 75% and EBITDA margins of 12%. Notably, these margin levels represent a slight acceleration for 2H22 versus 1H22, based on better hospital staffing levels and procedures and revenue leverage from new product launches.

Netting its $60 million in cash and no debt, OFIX has an enterprise value of $324 million. With the company reiterating its 2022 revenue and EBITDA guidance in September, at the Sidotti conference, OFIX is trading at 0.7x revenue and 5.9x EBITDA at quarter end. These multiples are at a significant discount to peers (GMED, NUVA, ATEC) of 2.5x-5.0x revenues and 10x-14x EBITDA (ATEC is excluded due to negative EBITDA), and a significant discount to OFIX's own history of 10x-15x+ EBITDA. We have conservatively set our PT at $30, up 57% from quarter end trading values, but likely to rise if OFIX delivers on its targets as we expect. With $60 million net cash, accelerating revenues and new product offerings in the works, we think OFIX could likely attract takeover interest if valuations don't rise, as insiders own only approximately 3.55% of the shares.[11]

Looking Forward

It matters when it matters. This investment mantra continues to prove a important lesson for long-term investors. While we aniticipated higher inflation and aggressive Fed rate hikes in 2022, 3Q22 proved to be a violent pivot point for investors in general who moved as a galloping herd to sell stocks.

While the market will likely be bumpy through 4Q22, we are comfortable with maintaining our long-term view on the companies we own. By early 2023, market pundits could be dicusssing the buying opportunities they missed in late 2022.

We don't own the market. We own 26 distinct companies with unique investment cases, built off strong balance sheets, visible growth scenarios and significantly positive risk versus reward characteristics. We have not built our valuation targets off unrealistically low interest rate levels, and we have focused on companies that can weather the storm and raise prices to over come inflationary headwinds.

We thank you for your trust and support. As always, please do not hesitate to contact us for client service, to discuss our commentary or to simply opine on the market and stocks.

-Chip

1. Past performance is no guarantee of future results. The RAM SMID Value Composite schedule of net investment performance of Rewey Investment Management LLC (the "Schedule") represents the activity of separate customer trading accounts managed collectively (collectively the "Accounts") for the annual and cumulative periods from January 1, 2019 through June 30, 2022. 2022 performance unaudited. Please see full Marcum footnotes for RAM Smid composite 2019-2021 at Microsoft Word - {A44BB912-3141-4B59-AE8E-3D695C6B8BD4} (reweyassetmanagement.com). Performance graphic not to scale.
2. The Russell 2500 Value, the S&P 500 and Nasdaq Composite Index performance levels are sourced from Bloomberg. The Russell 2500 Value, S&P 500 and Nasdaq Composite indicies are an unmanaged group of securities considered to be representative of the small and mid-cap stock market, and the large-cap stock market in general, respectively. Indexes are unmanaged and do not incur management fees, costs, or expenses. It is not possible to invest directly in an index. There are material differences between the RAM SMID Value Composite portfolio and the indexes used for comparison purposes. The RAM portfolio is actively managed and holds concentrated investments in the equity securities of small-mid capitalized companies. An index is generally designed to illustrate the performance of a specific asset class (i.e. small cap), but is not actively managed and the index performance does not reflect the impact of advisory fees and other investment costs.
3. U.S. Federal Reserve Press Conference transcript 9/21/22 Transcript of Chair Powell's Press Conference September 21, 2022 (federalreserve.gov)
4. Change in Non-Farm Payrolls, Average Hourly Earnings and JOLTS data sourced from the Bureau of Labor Statistics, via Bloomberg.
5. U.S. Federal Debt 9/29/22 Debt to the Penny | U.S. Treasury Fiscal Data
6, 8. All portfolio discussion is based off our model RAM Smid portfolio of separately managed accounts. Company financial estimates sourced from Rewey Asset Management proprietary analysis, and Bloomberg BEST company estimates. Historical pricing and company financial data sourced from company 10Q and 10K filings, and Bloomberg. Individual portfolios may hold slight deviations in position sizes, cash levels and positions held.
7. Covering active sell-side analyst data sourced from Bloomberg.
9. Cadence Bank (CADE) quarterly performance information sourced from Bloomberg. Other CADE commentary sourced from company earnings releases, 10Q, 10K filings, company presentations, Bloomberg and Rewey Asset Management proprietary analysis.
10. Stratec Security (STRT) quarterly performance information sourced from Bloomberg. Other STRT commentary sourced from company earnings releases, 10Q, 10K filings, company presentations, Bloomberg and Rewey Asset Management proprietary analysis.
11. All financial ratios, statistics, and projections discussed in the Orthofix Medical (OFIX) commentary are sourced from OFIX 10-K and 10Q filings, company press releases, company public conference calls and webcasts, company slide presentations, OFIX company webpage, RAM discussions with PVH management and Rewey Asset Management proprietary financial analysis and Rewey Asset Management industry due diligence. Historical share price information sourced from Bloomberg. CMED, NUVA and ATEC prices and estimates sourced from Bloomberg.

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